

No. 14402

United States
Court of Appeals
for the Ninth Circuit.

OTIS A. KITTLE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court
of the United States

FILED

FEB 17 1955

PAUL P. O'BRIEN,

CLERK



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

KENNETH P. DILLON, ESQ.

For Respondent:

EDWARD H. BOYLE, ESQ.

The Tax Court of the United States

Docket No. 35,442

OTIS A. KITTLE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1951

June 25—Petition received and filed. Taxpayer notified. Fee paid.

June 26—Copy of petition served on General Counsel.

June 25—Request for Circuit hearing in San Francisco, Calif., filed by taxpayer. 7/5/51. Granted.

Aug. 8—Answer filed by General Counsel.

Aug. 17—Copy of answer served on taxpayer, San Francisco, Calif.

1952

May 31—Hearing set July 28, 1952, San Francisco, Calif.

Aug. 4—Hearing had before Judge Bruce on merits, stipulation of facts filed at hearing, petitioner's brief 9/18/52; respondent's brief 10/20/52; reply 11/10/52.

Aug. 22—Transcript of hearing 8/4/52, filed.

1952

- Sept. 15—Brief filed by taxpayer. Copy served.
- Oct. 20—Motion for extension to Oct. 27, 1952, to file brief filed by General Counsel. 10/21/52. Granted.
- Oct. 27—Answer brief filed by General Counsel.
- Nov. 17—Motion for extension to Nov. 28, 1952, to file brief filed by taxpayer. 11/18/52. Granted.
- Nov. 28—Reply brief filed by taxpayer. Copy served 12/1/52.

1953

- Oct. 19—Findings of Fact and Opinion rendered. Judge Bruce. Decision will be entered under Rule 50. Copy served.

1954

- Jan. 7—Respondent's computation for entry of decision filed.
- Jan. 8—Hearing set 2/10/54, Washington, D. C., on respondent's computation.
- Jan. 26—Consent to respondent's computation for Entry of Decision filed by petitioner.
- Jan. 28—Decision entered. Judge Bruce. Div. 6.
- Apr. 22—Petition for Review by U. S. Court of Appeals for the Ninth Circuit filed by taxpayer.
- May 27—Order extending time to 7/21/54 for filing the record and docketing the appeal, entered.

1954

- June 7—Designation of contents of record on review with service acknowledged thereon, filed by taxpayer.
- June 8—Counter-designation of contents of record on review with proof of service by mail thereon, filed by General Counsel.
- June 17—Proof of service of petition for review filed.
-

[Title of Tax Court and Cause.]

FINDINGS OF FACT AND OPINION

Promulgated October 19, 1953

Petitioner held engaged in regularly carrying on a trade or business, and a net loss of \$14,032.34 realized by him in the calendar year 1947 was attributable to the operation of such business and subject to be carried back to the calendar year 1945 under sections 23(s) and 122, I.R.C.

Amounts received by petitioner in 1947 as payments under a lease of iron ore lands represented royalties payable upon production and not amounts received for the sale of ore in place. Such amounts held to represent ordinary income and not capital gain.

KENNETH P. DILLON, ESQ.,

For the Petitioner.

EDWARD H. BOYLE, ESQ.,

For the Respondent.

Respondent determined a deficiency in the income tax of the petitioner for the calendar year 1945 in the amount of \$160.71. The basic issue involved is whether petitioner is entitled to a net operating loss deduction for the calendar year 1945 under sections 23(s) and 122 of the Internal Revenue Code based on a net operating loss carry-back from the calendar year 1947, and, if so, in what amount. Determination of this basic issue presents the questions (1) whether petitioner's net loss incurred during 1947 in mining exploration and development work, amounting to \$14,032.34, represents a loss incurred by petitioner in regularly carrying on a trade or business within the meaning of section 122(d)(5) of the Internal Revenue Code; and (2) whether amounts received by petitioner in 1947 as payments under a so-called amended lease of mine lands represent capital gain or ordinary income. Certain adjustments made by respondent in determining the deficiency are not in issue.

Findings of Fact

Certain of the facts were stipulated and are so found.

Petitioner is an individual residing in Bishop, California. His return for the period involved, namely, the calendar year 1945, was filed with the collector of internal revenue for the District of Nevada. The petitioner filed an amended income tax return for the calendar year 1945 claiming a net operating loss deduction of \$8,912.05, said claimed deduction being attributable to a net oper-

ating loss carry-back from the calendar year 1947.

As of January 1, 1946, the petitioner was the owner of a $1/63$ interest in certain capital assets, namely, the mineral rights appurtenant to certain Minnesota iron ore properties commonly known as the "Rust Mine Lands." For many years prior to January 1, 1946, the aforesaid properties were operated by Oliver Iron Mining Company, a corporation, as assignee of Lake Superior Consolidated Iron Mines, a corporation, as lessee, under a lease dated October 2, 1899, naming the petitioner's predecessors in interest and certain others as lessors. As of January 1, 1946, the petitioner and other owners of percentage fee interests in the aforesaid properties, as lessors, and Oliver Iron Mining Company, as lessee, executed an amended lease, incorporated herein by reference. By the aforesaid amended lease, petitioner became entitled to receive during the first twenty-year period of the fifty-year extension of the lease from Oliver Iron Mining Company, a $1/63$ of \$10,000,000 or \$158,730.16. Said aggregate amount of \$10,000,000 was stated in said amended lease to be computed at the rate of 50c per ton for the first 20,000,000 tons of iron ore to be mined and shipped by the lessee from the aforesaid properties, payable by quarter annual payments of \$125,000 payable on the twenty-fifth days of April, July, October and January in each year, and continuing to and including January 25, 1966, petitioner's share of said quarter annual payments being $1/63$ of \$125,000, or \$1,984.13. Under the aforesaid amended lease,

the lessee assumed and agreed to pay said quarter annual payments as an unconditional continuing corporate obligation, irrespective of the quantity of iron ore actually shipped from said properties during any year or quarter thereof and notwithstanding any termination of the lease, including the right of lessee thereafter to mine or ship ore from, or continue in possession of, said properties. During the calendar year 1947, the petitioner received from Oliver Iron Mining Company amounts which aggregated \$7,936.52, representing his undivided interest in the quarter annual payments under said amended lease. The petitioner's undepleted cost attributable to the aforesaid payments received in 1947 amounted to \$969.40. The petitioner paid or incurred, during the calendar year 1947, as expenses in connection with the aforesaid payments received by him in that year, a total of \$424.54.

During the calendar year 1946, the petitioner commenced and engaged in mining exploration and development work with respect to certain mining properties in the state of Nevada, namely, the "Florence Mine" and the "Richmond Mine" in Nye County, the "Bull Run District Mine" in Elko County, and the "Springmeyer Mine" and "Carbonate Hill Mine" in Douglas County, in connection with which exploration and development work he paid or incurred expenses during 1946 aggregating \$8,197.53, there being no receipts. Petitioner's mining and exploration work with respect to said properties was discontinued within the same year, and at the end of that year he retained no

further interest of any nature whatsoever in said properities. For the calendar year 1946, the petitioner duly filed an income tax return disclosing a net loss from mining exploration in the amount of \$8,197.53 in Schedule C of said return. During the calendar year 1946, petitioner also commenced and engaged in mining and exploration work with respect to three other mines within the state of Nevada, namely, the "Clay Peters Mine," "Gooseberry Mine" and "McCoy Mine," in connection with which he paid or incurred expenses during 1946 aggregating \$404.06. As of the close of the year 1946, petitioner was still engaged in mining exploration and development work with respect to said mines. Said expenses of \$404.06 were capitalized and deferred by the petitioner on his books of account and not deducted in his Federal income tax return for 1946.

During the calendar year 1947, the petitioner commenced and engaged in mining exploration and development work with respect to the "McNamara Mine," "Commodore Mine," "Vista Mine," "McAdoo Mine" and "Wellington Tungsten Mine," all located in the state of Nevada, and the "Lordsburg Mine" located in the state of New Mexico, in connection with which work he paid or incurred expenses during 1947 aggregating \$13,664.32. Petitioner discontinued mining exploration and development work with respect to all said properties and with respect to the three mines referred to above on which work had been commenced and not completed in 1946, within the year 1947, and at the end

of said year retained no interest of any nature whatsoever in said properties. For the calendar year 1947, petitioner duly filed a Federal income tax return disclosing in Schedule C thereof a net loss from mining exploration in the aggregate amount of \$14,032.34, representing the total of the aforesaid amounts of \$404.06 and \$13,664.32, net of gross receipts of \$36.04, said net loss in the amount of \$14,032.34 representing a proper deduction for the taxable year 1947. During said years 1946 and 1947, petitioner's only sources of gross income, other than from mining exploration and development, were dividends, interest, capital losses from security transactions, and the receipts and items referred to above from the Oliver Iron Mining Company.

Petitioner is a mining engineer, having been graduated from the Mackay School of Mines of the University of Nevada. He was in the military service from May 12, 1942, to February 26, 1946. After discharge he established residence in Reno, Nevada, and began looking around for mining properties which might be explored and developed. About July 1, 1946, he employed Victor E. Kral, also a graduate of Mackay School of Mines, on a small salary with the understanding that if anything worth while was found the latter would receive ten per cent of the net profits therefrom. He established and maintained an office in Reno during 1946 and 1947, as Otis A. Kittle, Mining Exploration, a proprietorship. In the beginning petitioner

contemplated limiting his expenditures in this enterprise to approximately \$10,000 but added to this sum as successive properties were examined. Kral acted as business manager and kept records of the company's expenses, such expenses being segregated or allocated for each property explored. Kral also made examinations and samplings of some of the properties. At times when needed, less experienced engineers were also employed by petitioner to assist in this work.

The exploration work conducted by petitioner and Kral during 1946 and 1947 included physical examination, sampling, assays, mapping, diamond drilling, drafting and trenching operations. The equipment used, with the exception of a double drum slusher, was small, portable and suitable only for mine exploration and development work rather than commercial production. Upon abandonment of any particular mining property the equipment being used thereon was moved directly to another property or held at the office in Reno until needed on another property. The properties thus explored by petitioner were usually ones which had previously been the subject of exploration or mining which had been discontinued. Petitioner's arrangements with the property owners were usually verbal, or if written, tentative, providing for a period of 30, 60 or 90 days for examination, sampling and assaying preliminary to the signing of written leases or options if the property appeared sufficiently interesting to petitioner.

It was petitioner's intention, if his exploration

and development work disclosed any property with sufficient possibilities for commercial production to convey his interest to others or to organize a new enterprise with sufficient capital for beneficiation. If the showing was only small he might have attempted to remove the ore and sell it to some custom plant for further processing. In either event he would have continued his exploration and development work looking for additional ore bodies.

Petitioner continued in his exploration and development work until the end of 1949. Kral continued in his employment until March, 1949. There were other concerns in Nevada engaged in exploration and development work as a well-defined activity distinct from commercial production.

Petitioner was engaged in regularly carrying on the trade or business of mine exploration and development during the calendar years 1946 and 1947 and the net loss in the amount of \$14,032.34 incurred by petitioner during the calendar year 1947 was attributable to the operation of such business.

Opinion

Bruce, Judge:

Petitioner claims a net operating loss deduction for the calendar year 1945 under sections 23(s) and 122 of the Internal Revenue Code,¹ based upon a

¹Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * *

(s) Net Operating Loss Deduction — For any

net operating loss carry-back from the calendar year 1947. The first question for determination is whether petitioner's net loss incurred during 1947 in mine exploration and development work, amounting to \$14,032.34, represents a loss incurred by petitioner in regularly carrying on a trade or business within the meaning of section 122(d)(5).

It is not disputed that during the calendar year 1947 petitioner suffered a net loss from his mining exploration work in the aggregate amount of \$14,032.34, and that such net loss represented a taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * *

Sec. 122. Net Operating Loss Deduction.

(a) Definition of Net Operating Loss—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

* * *

(d) Exceptions, Additions, and Limitations—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

* * *

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions, additions, and limitations specified in paragraphs (1) to (4) of this subsection. * * *

proper deduction for the taxable year 1947. Respondent contends, however, that such loss was not incurred by petitioner in regularly carrying on a trade or business within the meaning of section 122(d)(5). As a basis of his contention respondent argues that it is not possible from the record to ascertain what petitioner's business was, or what course he would have followed if ore had been discovered, so as to realize a profit or income. Assuming petitioner would have actively mined any discovery made or would have leased the mineral rights to third parties, respondent asserts the expenditures incurred in 1947 in connection with the discovery would not have been deductible as operating expenses but, pursuant to the requirements of Reg. 111, section 29.23(m)-15,² would have been capital items recoverable only through deduction for depreciation and depletion, citing Rialto Mining Corp., 25 B.T.A. 980, and G. E. Cotton, 25 B.T.A. 866. Respondent concedes that if it be assumed petitioner would have sold the mineral rights to

²Sec. 29.23(m)-15.

Allowable Capital Additions in Case of Mines—
(a) All expenditures in excess of net receipts from minerals sold shall be charged to capital account recoverable through depletion while the mine is in the development stage. The mine will be considered to have passed from a development to a producing status when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining.

third parties, petitioner would be in the business of selling mineral properties and the expenditures incurred in 1947 would have constituted operating expenses rather than the cost of each mine or mineral property.

Petitioner contends, however, that his business consisted of exploring and developing mineral properties as distinct from the business of commercial mining production and therefore that the loss incurred therein represents deductions otherwise allowed by law attributable to the operation of a trade or business regularly carried on within the meaning of section 122(d)(5) of the Internal Revenue Code.

We agree with petitioner's position. That he followed a regular course of action cannot be denied. Beginning in 1946, after his release from the military service, and continuing through 1949, petitioner employed all his business energies and time in the exploration and development of mining properties. He established and maintained an office for such business, kept records of expenditures, and employed others to assist him. His working assets were the \$19,000 or more which he allocated for such work, his engineering abilities, and personal services. The fact that he never realized any income from his activities (except an unexplained item of \$36.04) does not of itself prevent such activities from constituting a trade or business. As respondent on brief has stated, the question of whether or not the net loss incurred in 1947 should be deemed attributable to the operation of a trade or business, can-

not be held to turn upon petitioner's success or failure in discovering mineral properties. Nor do we think it material, under the facts of this case, what course petitioner would have pursued had he found a commercially productive ore body. Both petitioner and Kral testified that had such an ore body been discovered the beneficiation thereof would have been the subject of an entirely new enterprise and that they would have continued in their activities of exploring and developing other ore bodies. Had he discovered an ore body in any of the properties examined worthy of commercial production his interest therein would unquestionably have been capable of evaluation and such evaluation would have been recognized by way of cash, stock, or partnership interest by any company organized to exploit such ore deposits. Such valuation would have represented income of petitioner's business of exploration and development of mineral properties. Petitioner's business was not merely that of a particular venture or development of a particular mining lease as in the Rialto and Cotton cases, *supra*. The various mining properties explored were not isolated transactions but part of his regular business and the losses incurred were from the operation of a business regularly carried on by him. Such losses incurred in 1947 are accordingly eligible for carry-back to the calendar year 1945 under the provisions of sections 23(s) and 122 of the Internal Revenue Code. See Oscar K. Eysenbach, 10 B.T.A. 716; Royal W. Irwin, 37 B.T.A. 51; Henry E. Sage, 15 T.C. 299.

Having determined that the net loss incurred by petitioner during 1947 in mining exploration and development work, amounting to \$14,032.34, represents a loss incurred in regularly carrying on a trade or business and as such eligible for carry-back to the year 1945, it becomes necessary to determine whether amounts received by petitioner in 1947 as payments under a so-called amended lease of mine lands represent capital gain or ordinary income, in order that the amount of net operating loss available for carry-back may be determined.

As of January 1, 1946, petitioner, by succession in interest, was a party to a mining lease dated October 2, 1899. This lease, by its terms, was to run for a period of fifty years and three months, or until January 1, 1950, and provided for certain production and advance or minimum royalties.

The 1899 lease was considered in the case of *Estelle Burt DeVelin, et al., Trustees*, 22 B.T.A. 1400, wherein it was held that the royalty payments were ordinary income and not the proceeds of sale of any part of the land or other capital assets. Royalties paid to petitioner prior to 1946 were reported by him in his income tax returns as ordinary income.

As of January 1, 1946, petitioner and other successors to the original interests of the lessors under the 1899 lease entered into an "Amended Lease" of the Rust Mine Lands with Oliver Iron Mine Company, the successor in interest of the lessee. This amended lease was to run for a period of fifty years from January 1, 1946, and its stated purpose

was "to extend the term of said [1899] mining lease and to make certain other modifications thereof." Petitioner's position is that under the amended lease he, as owner of a 1/63 interest of the mineral rights appurtenant to the Rust Mine Lands, effected a sale of his pro rata share of 20,000,000 tons of ore in place.

The amended lease, which is included in the record by stipulation, is quite lengthy, containing some 56 separate paragraphs. It need not all be here set out, as we are concerned merely with those sections which determine the nature of the instrument and the character of the payments provided to be made, to wit, whether it is a lease of the lands providing for royalty payments to the lessors who, under its terms, retained an economic interest in the minerals to be mined by the lessee, or whether it is a contract of sale of such minerals in place and the payments provided to be made are merely ones in consideration of such conveyance. The pertinent provisions of the lease are as follows:

1. That the Lessors, in consideration of the sum of one dollar (\$1.00) to them paid by the Lessee, the receipt whereof is hereby acknowledged, and in further consideration of the covenants, conditions, and provisions of this lease to be kept and performed by the Lessee, do hereby let, demise and lease unto the Lessee, for the further term of fifty (50) years from and after the first day of January in the year one thousand nine hundred and forty-six, the following described lands and premises in the County of St. Louis and State of Minnesota,

hereinafter referred to as the "Rust Mine Lands,"
to wit:

* * *

4. The Rust Mine Lands are demised to the Lessee for the purpose of exploring for mining, taking out and shipping therefrom the merchantable iron ore (as well as other minerals as hereinafter provided for) which is or hereafter may be found on, in or under the Rust Mine Lands, with the right to the Lessee to construct all buildings and to make all excavations, openings, ditches, drains, railroads, roads and all other improvements which are or may become necessary or suitable for the mining or removing of the iron ore therefrom and the carrying on of mining operations thereon. The term "merchantable ore" as used in this lease shall be taken to mean such ore as shall be merchantable from time to time as the work of mining progresses.

5. The Lessee hereby covenants and agrees to pay to the Lessors a royalty on all iron ore mined and shipped from the Rust Mine Lands while this lease shall remain in force, as follows:

6. Upon the first twenty million (20,000,000) tons of iron ore mined and shipped by the Lessee from the Rust Mine Lands the royalty shall be at the rate of fifty (50) cents for each gross ton of 2240 pounds avoirdupois.

* * *

9. The Lessee further covenants and agrees that for each year prior to January 1, 1966, it will pay

to the Lessors the sum of Five Hundred Thousand Dollars (\$500,000.00), payable quarterly on the twenty-fifth days of April, July, October and January in each year, irrespective of the quantity of iron ore actually shipped from the Rust Mine Lands during such year or any quarter thereof, and the total amount so paid, including the final payment on January 25, 1966, shall satisfy the royalty of fifty (50) cents per ton on the first twenty million (20,000,000) tons of ore shipped from the Rust Mine Lands.

10. If, prior to January 1, 1966, less than twenty million (20,000,000) tons of ore shall have been shipped from the Rust Mine Lands, the balance of said twenty million (20,000,000) tons of ore, upon which the royalty shall have been paid as above provided, on or before January 25, 1966, may be shipped, without further payment of royalty thereon, at any time thereafter during the existence of this lease; but the shipment thereof shall not be taken to satisfy or affect in any way the minimum requirements after January 1, 1966, hereinafter provided for.

11. If, prior to January 1, 1966, the Lessee shall ship, as it may, more than twenty million (20,000,000) tons of iron ore from the Rust Mine Lands, the Lessee shall pay to the Lessors, in addition to the quarterly payments to be made as aforesaid, the base royalty on all such ore in excess of the said twenty million (20,000,000) tons shipped during each quarter year, payable on the twenty-

fifth day of the month following the end of such quarter; and the excess royalty, if any, thereon, shall be paid on the twenty-fifth day of July of the year following the year in which such ore was shipped.

* * *

47. Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore theretofore mined, or to continue in possession of the Rust Mine Lands, any unpaid balance of the total amount of Ten Million Dollars (\$10,000,000) payable as royalty on twenty million (20,000,000) tons of ore as aforesaid, shall nevertheless be paid by the Lessee to the Lessors in quarterly installments of One Hundred Twenty-five Thousand Dollars (\$125,000.00) each, on the 25th days of April, July, October and January in each year, until said amount is fully paid; and for an adequate consideration such obligation is hereby assumed and agreed to be paid as a continuing corporate obligation of said Lessee.

* * *

The principle is well settled that the holder of a royalty interest in natural resources possesses an economic interest in the minerals in place. *Palmer v. Bender*, 287 U.S. 551; *Burnet v. Harmel*, 287 U.S. 103; *Murphy Oil Co. v. Burnet*, 287 U.S. 299. It is also well settled that cash bonus payments or advanced royalties when incident to a royalty interest have the same character as royalty payments

made under the contract for mineral extracted. *Burnet v. Harmel*, supra; *Bankers' Pocahontas Coal Co. v. Burnet*, 287 U.S. 308; *Herring v. Commissioner*, 293 U.S. 322. The above cited cases determined definitely that such payments represent ordinary income to the lessor, taxable as such, and not capital gain received from the sale of the mineral in place. *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25.

The contract here in question is designated by the contracting parties as a lease, and the payments to be made under its terms are characterized as royalties. Those payments to be made prior to extraction of the mineral are termed prepaid royalties and the payments to be made extend over the term of the lease and under its terms are measured by production. Both the original 1899 lease and the amended lease of 1946 carry the identical provision that

The Lessee hereby covenants and agrees to pay to the Lessors a royalty on all iron ore mined and shipped from the Rust Mine Lands while this lease shall remain in force, * * *

The petitioner's theory is that by paragraphs 9 and 47 of the amended lease the payments agreed to be made are converted from royalty payments to ones in exchange for a transfer of title to 20,000,000 tons of ore in place. With this we do not agree. Paragraph 9 merely obligates the lessee to pay the lessors \$10,000,000 over the first twenty-year period of the lease even though the full amount of 20,000,000 tons of ore is not extracted during

such period. This is merely a provision for minimum royalties. *Bankers' Pocahontas Coal Co. v. Burnet*, supra. This is clear if the paragraph in question is construed, as it must be, with the two following paragraphs, 10 and 11, which provide that if less than the 20,000,000 tons shall have been mined and shipped prior to 1966, the balance of such tonnage may be taken without further payment of a royalty, and that any excess over the 20,000,000 tons mined and shipped by the lessee during the lease period shall carry an additional royalty payment at a specified rate.

We think it clear that these prepaid royalties required of the lessee under the contract are identical in character to the advanced royalties or cash bonus payments involved in *Burnet v. Harmel*, supra, and *Bankers' Pocahontas Coal Co. v. Burnet*, supra.

Petitioner, in support of his position, asserts that under the contract the lessee has bound itself independently under a "corporate liability" to pay the full amount of \$10,000,000 irrespective of the amount of production. On this basis it is argued that the lessor does not here have to look to the actual extraction of the mineral for the recovery of this sum. Similar argument was made and rejected in the cases above cited respecting bonus and advance royalty payments. As was said by the court in *Burnet v. Harmel*, supra:

* * * the payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose

of exploiting it, as well as for the ownership of the oil and gas; under both the bonus payments are paid and retained, regardless of whether oil or gas is found, and despite the fact that all which is not abstracted will remain the property of the lessor upon termination of the lease.

* * *

Bonus and royalties are both consideration for the lease, and are income of the lessor. We cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production. * * *

The effect of paragraph 47 merely makes clear the obligation of the lessee to pay the full amount of the minimum royalty provided even if the lease be terminated. The fact that this liability is specifically provided to be a corporate liability of the lessee is, we think, without any special significance. It would be such a liability in any case where the lessee was a corporation unless by some specific provision of the lease or by act of the lessor the corporation would be exempted from the liability assumed to make full payment of the advance royalties agreed upon.

Petitioner bases his contention upon the decision in *Anderson v. Helvering*, 310 U.S. 404. It is argued that certain of the language used by the court in that case is applicable to the situation here shown to exist. The language in question, however, was

used with respect to a situation entirely different in character to that here presented. There the court had a case of an outright sale and conveyance of property for a fixed consideration of money. This property consisted of an aggregate of certain royalty interests, fee interests and deferred oil payments. There the seller sought depletion allowance upon the purchase price by reason of the fact that it had, under the contract of sale, as security for the payment agreed to be made, retained a lien upon 50 per cent of the proceeds of the production of oil and oil payments and also upon the proceeds of any sale of the properties conveyed in fee. The court held that the seller of the properties had retained no economic interest measured by production, the amount payable to him not being fixed by production of oil and with the possibility that it be satisfied in full from the proceeds of the sale by the purchaser of the properties conveyed in fee.

We think the case of *Anderson v. Helvering*, supra, has no application to the question here. That case was decided subsequent to most of the cases which we have heretofore cited as laying down the rules under which the retention of an economic interest is to be determined. It in no sense purports to limit or restrict the meaning or effect of the court's decisions in those cases, the court having cited them as authority for the conclusion which it reached.

We sustain the respondent in his determination that the amount received by the petitioner as an owner of an interest in Rust Mine Lands and under

the amended lease of January 1, 1946, constitutes ordinary income and not capital gain.

Decision will be entered under Rule 50.

Served October 19, 1953.

The Tax Court of the United States
Washington

Docket No. 35,442

OTIS A. KITTLE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of this Court promulgated October 19, 1953, the respondent, on January 7, 1954, filed his computation under Rule 50 of the Court's Rules of Practice, which computation has been agreed to by the petitioner. In accordance therewith, it is

Ordered and Decided that there is an overpayment of \$2,024.10 in income tax for 1945.

[Seal] /s/ J. GREGORY BRUCE,
 Judge.

Entered January 28, 1954.

Served January 29, 1954.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by their respective counsel, that the facts hereinafter stated shall be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce upon the trial of this case any other and further evidence not inconsistent with the facts herein stipulated.

1. The Petitioner is an individual residing at P.O. Box 478, Bishop, California.

2. The return for the period involved, namely, the calendar year 1945, was filed with the Collector of Internal Revenue for the District of Nevada.

3. The Notice of Deficiency, a copy of which is attached to the Petition on file herein as Exhibit A thereto, was mailed to the Petitioner on March 28, 1951.

4. The Commissioner determined a deficiency in Petitioner's income tax for the calendar year 1945 in the amount of \$160.71, of which the entire amount is in controversy.

5. The Petitioner filed an amended income tax return for the calendar year 1945, claiming a net operating loss deduction of \$8,912.05, said claimed deduction being attributable to a net operating loss carry-back from the calendar year 1947.

6. As of January 1, 1946, the Petitioner was the

owner of a 1/63 interest in certain capital assets, namely, the mineral rights appurtenant to certain Minnesota iron ore properties commonly known as the "Rust Mine Lands."

7. For many years prior to January 1, 1946, the aforesaid properties were operated by Oliver Iron Mining Company, a corporation, as assignee of Lake Superior Consolidated Iron Mines, a corporation, as lessee, under a lease dated October 2, 1899, naming the Petitioner's predecessors in interest and certain others as lessors. A copy of said lease of October 2, 1899, marked Exhibit A, is attached hereto and made a part hereof.

8. As of January 1, 1946, the Petitioner and other owners of percentage fee interests in the aforesaid properties, as lessors, and Oliver Iron Mining Company, as lessee, executed an Amended Lease, a copy of which, marked Exhibit B, is attached hereto and made a part hereof.

9. By the aforesaid Amended Lease, Petitioner became entitled to receive from Oliver Iron Mining Company a 1/63 of \$10,000,000, or \$158,730.16. Said aggregate amount of \$10,000,000 was stated in said Amended Lease to be computed at the rate of 50c per ton for the first 20,000,000 tons of iron ore to be mined and shipped by the lessee from the aforesaid properties, payable by quarter annual payments of \$125,000 beginning January 25, 1946, and continuing to and including January 25, 1966, Petitioner's share of said quarter annual payments being 1/63 of \$125,000, or \$1,984.13.

10. Under the aforesaid Amended Lease, the lessee assumed and agreed to pay said quarter annual payments as an unconditional continuing corporate obligation, irrespective of the quantity of iron ore actually shipped from said properties during any year or quarter thereof and notwithstanding any termination of the lease, including the right of lessee thereafter to mine or ship ore from, or continue in possession of, said properties.

11. During the calendar year 1947, the Petitioner received from Oliver Iron Mining Company amounts under the aforesaid Amended Lease which aggregated \$7,936.52, representing his undivided interest in the aforesaid quarter annual payments under said Amended Lease.

12. The Petitioner's undepleted cost attributable to the aforesaid payments received in 1947 amounted to \$969.40.

13. The Petitioner paid or incurred, during the calendar year 1947, as expenses in connection with the aforesaid payments received by him in that year, a total of \$424.54.

14. During the calendar year 1946, the Petitioner commenced and engaged in mining exploration and development work with respect to four mining properties in the State of Nevada, namely, the "Florence Mine" and the "Richmond Mine" in Nye County, the "Bull Run District Mine" in Elko County, and the "Springmeyer Mine" and "Carbonate Hill Mine" in Douglas County, in connection with which exploration and development

work he paid or incurred expenses during 1946 aggregating \$8,197.53, there being no receipts. Petitioner's mining and exploration work with respect to said properties was discontinued within the same year, and at the end of that year he retained no further interest of any nature whatsoever in said properties. For the calendar year 1946, the Petitioner duly filed an income tax return disclosing a net loss from mining exploration in the amount of \$8,197.53 in Schedule C of said return.

15. During the calendar year 1946, Petitioner also commenced and engaged in mining and exploration work with respect to three other mines within the State of Nevada, namely, the "Clay Peters Mine," "Gooseberry Mine" and "McCoy Mine," in connection with which he paid or incurred expenses during 1946 aggregating \$404.06. As of the close of the year 1946, Petitioner was still engaged in mining exploration and development work with respect to said mines. Said expenses of \$404.06 were capitalized and deferred by the Petitioner on his books of account and not deducted in his Federal income tax return for 1946.

16. During the calendar year 1947, Petitioner commenced and engaged in mining exploration and development work with respect to the McNamara Mine, Commodore Mine, Vista Mine, McAdoo Mine and Wellington Tungsten Mine, all located in the State of Nevada, and the Lordsburg Mine located in the State of New Mexico, in connection with which work he paid or incurred expenses during 1947 aggregating \$13,664.32. Petitioner discon-

tinued mining exploration and development work with respect to all said properties and with respect to the mines referred to in paragraph 15 hereof, within the year 1947, and at the end of said year retained no interest of any nature whatsoever in said properties.

17. For the calendar year 1947, Petitioner duly filed a Federal income tax return disclosing in Schedule C thereof a net loss from mining exploration in the aggregate amount of \$14,032.34, representing the total of the aforesaid amounts of \$404.06 and \$13,664.32, net of gross receipts of \$36.04, said net loss in the amount of \$14,032.34 representing a proper deduction for the taxable year 1947.

18. During said years 1946 and 1947, Petitioner's only sources of gross income, other than from mining exploration and development, were dividends, interest, capital losses from security transactions, and the receipts and items referred to above in paragraphs 11, 12 and 13.

Dated: August 4, 1952.

Respectfully submitted,

/s/ KENNETH P. DILLON,
Attorney for Petitioner.

/s/ CHARLES W. DAVIS,
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

EXHIBIT A

* * *

Second—The lessee hereby covenants and agrees

to pay to the lessors a royalty on all iron ore mined and shipped from the said lands while this lease shall remain in force, as follows:

For all iron ore mined and shipped * * * after the first day of January, A.D. 1900, the royalty shall be at the rate of twenty-five cents for each gross ton.

* * *

The lessee further covenants that in each year during the existence of this lease, after January 1, 1900, it will mine and ship from the said lands at least two hundred thousand gross tons of iron ore as an agreed minimum output, or, in case in any one or more of such years the lessee shall not actually ship from the demised premises the full quantity of said agreed minimum output, the lessee will, nevertheless, pay to the lessors advance royalty, to be treated and considered as ground rent, in addition to the royalty paid for iron ore actually shipped during that year, such sum as shall, together with the amount paid as royalty for iron ore actually shipped during the said year, amount to Fifty thousand dollars.

* * *

The obligation of the lessee to pay advance royalties as aforesaid shall continue in force without regard to the quantity or quality of iron ore existing on the premises during the full term of this lease or until the same shall be terminated or surrendered or assigned in the manner herein provided; and in case of an assignment of the said lease the obligation to mine or pay for such agreed

annual minimum output, as well as all other provisions of the lease, shall bind the assignee as fully as the lessee is bound hereby.

* * *

EXHIBIT B

Amended Lease
Rust Mine Lands

Estelle Rust, Edgar H. Ailes and Maxine Rust
Muirhead, as Trustees Under the Will of Ezra
Rust, Deceased, and Others,

As Lessors,

—to—

Oliver Iron Mining Company,

As Lessee.

Dated—January 1, 1946.

* * *

Agreement Effective Jan. 1, 1946

Now, Therefore, in consideration of the premises and of the mutual benefits to accrue to each of them by the making of this agreement, the parties hereto hereby agree unto and with each other that said mining lease shall be and is hereby amended as of January 1, 1946, so that said entire lease shall thereafter read as follows:

* * *

Covenant to Pay Royalty

5. The Lessee hereby covenants and agrees to pay to the Lessors a royalty on all iron ore mined

and shipped from the Rust Mine Lands while this lease shall remain in force, as follows:

Royalty on First 20,000,000 Tons

6. Upon the first twenty million (20,000,000) tons of iron ore mined and shipped by the Lessee from the Rust Mine Lands the royalty shall be at the rate of fifty (50) cents for each gross ton of 2240 pounds avoirdupois.

* * *

Quarterly Payments to Jan. 25, 1966

9. The Lessee further covenants and agrees that for each year prior to January 1, 1966, it will pay to the Lessors the sum of Five Hundred Thousand Dollars (\$500,000.00), payable quarterly on the twenty-fifth days of April, July, October and January in each year, irrespective of the quantity of iron ore actually shipped from the Rust Mine Lands during such year or any quarter thereof, and the total amount so paid, including the final payment on January 25, 1966, shall satisfy the royalty of fifty (50) cents per ton on the first twenty million (20,000,000) tons of ore shipped from the Rust Mine Lands.

* * *

Quarterly Payments to Continue Until
\$10,000,000 Has Been Paid

47. Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore theretofore mined, or to continue in possession of the Rust

Mine Lands, any unpaid balance of the total amount of Ten Million Dollars (\$10,000,000) payable as royalty on twenty million (20,000,000) tons of ore as aforesaid, shall nevertheless be paid by the Lessee to the Lessors in quarterly installments of One Hundred Twenty-five Thousand Dollars (\$125,000.00) each, on the 25th days of April, July, October and January in each year, until said amount is fully paid; and for an adequate consideration such obligation is hereby assumed and agreed to be paid as a continuing corporate obligation of said Lessee.

* * *

Filed at hearing August 4, 1952.

[Title of Tax Court and Cause.]

PETITION FOR REVIEW OF DECISION
OF TAX COURT

Otis A. Kittle respectfully says:

1. He filed his 1945 individual income tax return with the Collector of Internal Revenue for the District of Nevada, within the Ninth Circuit.

2. In said return he claimed a credit for loss carry-back from the year 1947 which credit was disallowed by the Commissioner but was allowed in principle by the Tax Court.

3. In his return for 1947, petitioner claimed that he had sold a capital asset under an agreement with Oliver Iron Mining Company as of January 1, 1946, but the Commissioner and the Tax Court held that the transaction was a lease on a royalty

basis, and the income therefrom in 1947 must be taxed as ordinary income. That item increased the taxable income for the year 1947 and thereby decreased the net loss for the year 1947, and thus decreased the loss carry-back as a credit against 1945 income.

4. Decision of the Tax Court was entered January 28, 1954, as follows:

“It is ordered and decided that there is an overpayment of \$2,024.10 in income tax for 1945.”

5. Petitioner asks review of that order and decision to the extent that the overpayment was limited to \$2,024.10 by reason of the determination by the Tax Court that the income from Oliver Iron Mining Company in 1947 was ordinary income and not thereby treated as proceeds from the sale of a capital asset, as set forth in opinion of the Tax Court promulgated October 19, 1953, (21 T. C. No. 10).

6. Petitioner asks review by the United States Court of Appeals for the Ninth Circuit.

/s/ KENNETH P. DILLON,

Attorney for Petitioner.

Received and filed April 22, 1954, T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Victor S. Mersch, Clerk of the Tax Court of the United States, do hereby certify that the fore-

going documents, 1 to 13, inclusive, constitute and are all of the original papers and proceedings on file in my office as called for by the "Designation of Contents of Record on Review" and "Counter-Designation for Record on Review" in the proceeding before the Tax Court of the United States entitled "Otis A. Kittle, Petitioner, vs. Commissioner of Internal Revenue, Respondent, Docket No. 35442" and in which the petitioner in the Tax Court has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceeding, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 21st day of June, 1954.

[Seal] /s/ VICTOR S. MERSCH,
Clerk, the Tax Court of the
United States.

[Endorsed]: No. 14402. United States Court of Appeals for the Ninth Circuit. Otis A. Kittle, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of the Tax Court of the United States.

Filed June 24, 1954.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the
Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 14402

OTIS A. KITTLE,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

STATEMENT OF POINT TO BE RELIED
ON BY APPELLANT

By the terms of the amended lease of January 1, 1946, the sum of \$7,936.52 received thereunder by appellant in 1947 constituted part of the proceeds from the sale of a capital asset and is not taxable as ordinary income.

Dated: September 30, 1954.

VARGAS, DILLON &
BARTLETT,

By /s/ KENNETH P. DILLON,
Attorneys for Petitioner.

[Endorsed]: Filed October 1, 1954.

[Title of Court of Appeals and Cause.]

STIPULATION

It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel, that:

1. The following provisions may govern the rec-

ord on this appeal in all further proceedings related thereto:

a. Any portions of Exhibits "A" and "B" to the Stipulation of Facts incorporated in the record on review may be considered in their original form to the extent not designated for inclusion in the printed record.

b. The income tax returns constituting respondent's Exhibits C, D and E in the record on review may be considered in their original form without the necessity of reproducing them, the same not having been included in the printed record.

2. The decision of the Tax Court entered January 28, 1954, in this case ordering and deciding that there is an overpayment for 1945 shall be modified by the addition of the following: and that such portion of the tax was paid after the mailing of the notice of deficiency. Section 322(d)(1)(D), Internal Revenue Code of 1939.

Dated: January 10, 1955.

/s/ H. BRIAN HOLLAND,
Assistant Attorney General,
Attorney for Respondent.

/s/ KENNETH P. DILLON,
Attorney for Petitioner.

[Endorsed]: Filed January 12, 1955.

